

Message Text

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SUBJECT: VENEZUELAN ECONOMIC OUTLOOK

1. SUMMARY. 1977 WAS ANOTHER GOOD YEAR FOR VENEZUELA, CONTINUING THE TREND INITIATED WITH THE SUDDEN INFLOW OF OIL INCOME IN 1973. WE EXPECT THIS GROWTH TO CONTINUE DURING THE NEXT 12-18 MONTHS, BUT AT A MODERATING RATE. THE VENEZUELAN ECONOMY IS EXPERIENCING A NUMBER OF PROBLEMS WHICH NORMALLY CHARACTERIZE RAPID GROWTH, INCLUDING SURGING IMPORTS, PRICE INFLATION, ESCALATING GOVERNMENT EXPENDITURES AND SHORTAGES OF SKILLED MANPOWER. BECAUSE 1978 IS AN ELECTION YEAR, THE RULING AD PARTY WILL TEND TO DEFER THE TOUGH DECISIONS NECESSARY TO DEAL WITH THESE ISSUES IN AN EFFECTIVE WAY, PREFERRING TO LEAVE THEM TO THE NEW ADMINISTRATION WHICH TAKES OFFICE IN 1979. AS A RESULT, CENTRAL GOVERNMENT OUTLAYS IN 1978 MAY APPROACH BS.58 BILLION, THE TRADE SURPLUS IS EXPECTED TO DISAPPEAR, INFLATIONARY PRESSURES WILL CONTINUE AND THE GOV WILL BE FORCED TO BORROW HEAVILY IN INTERNATIONAL MONEY MARKETS. WHILE PUBLIC SECTOR SPENDING WILL BE MAINTAINED AT A HIGH LEVEL, INCLUDING INVESTMENT IN MAJOR DEVELOPMENT PROJECTS, PRIVATE SECTOR INVESTMENT WILL TEND TO DIMINISH AS THE ELECTION APPROACHES, AND DECISION MAKERS ADOPT A WAIT-AND-SEE ATTITUDE. THE NEW
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PRESIDENT'S DECISIONS IN THE AREAS OF TAXES, GOVERNMENT SPENDING, IMPORT RESTRAINTS AND INFLATION DURING 1979 ARE EXPECTED TO HAVE A NET DEFLATIONARY IMPACT ON THE ECONOMY. THUS WE ANTICIPATE A PAUSE DURING THE FIRST PART OF 1979, FOLLOWED BY A RESUMPTION OF REAL GROWTH, BUT AT A LOWER RATE THAN THE 1974-77 BOOM PERIOD. THESE CONCLUSIONS ASSUME A CONTINUATION OF POLITICAL STABILITY IN THE COUNTRY AND PETROLEUM EARNINGS DURING THE NEXT TWO YEARS

AT AT LAST THE 1977 LEVEL. END SUMMARY.

2. VENEZUELA ENTERS 1978 WITH A STRONG ECONOMY AND GOOD PROSPECTS, ALTHOUGH PROBLEMS ARE DEVELOPING. MAJOR ASSETS INCLUDE:

--SUBSTANTIAL DEPOSITS OF OIL IN DEVELOPED FIELDS WHICH WILL ENABLE VENEZUELA TO PRODUCE OIL AT THE CURRENT LEVELS FOR AN ESTIMATED 20 YEARS, ASSUMING THAT THERE IS ADEQUATE INVESTMENT IN EXPLORATION AND PLANT & EQUIPMENT.

1977, VENEZUELA EXPORTED AN AVERAGE OF ABOUT TWO MILLION BARRELS OF PETROLEUM AND PETROLEUM PRODUCTS A DAY, THUS EARNING ABOUT \$9.5 BILLION FROM THIS SOURCE FOR THE YEAR. WE EXPECT EARNINGS TO BE MAINTAINED AT ABOUT THIS LEVEL DURING 1978, PERHAPS SOMEWHAT LOWER.

--IMPORTANT UNDEVELOPED DEPOSITS OF OIL WHICH POTENTIALLY COULD MAKE VENEZUELA A MAJOR EXPORTER WELL INTO THE 21ST CENTURY.

--\$8.1 BILLION IN FOREIGN EXCHANGE RESERVES, EQUIVALENT TO ABOUT ONE YEAR OF IMPORTS.

--A SEEMINGLY UNIMPAIRED ABILITY TO BORROW INTERNATIONALLY. VENEZUELA HAS BORROWED ABOUT \$2.8 BILLION IN THE LAST 15 MONTHS, THE MAJORITY OF WHICH WAS EARMARKED FOR MAJOR DEVELOPMENT PROGRAMS. WE ANTICIPATE THE GOV WILL SEEK TO BORROW LIMITED OFFICIAL USE

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AN ADDITIONAL \$3-4 BILLION IN 1978. ACCORDING TO FOREIGN BANK REPRESENTATIVES IN VENEZUELA, THE GOV SHOULD HAVE NO MAJOR PROBLEMS OBTAINING MORE MONEY, ALTHOUGH THE TERMS WILL PROBABLY BE LESS FAVORABLE THAN THOSE OBTAINED IN THE PAST.

--A RICH ENDOWMENT OF (NON-PETROLEUM) NATURAL RESOURCES, INCLUDING MAJOR DEPOSITS OF COAL, IRON ORE AND BAUXITE. THE COUNTRY IS ALSO BLESSED WITH AMPLE HYDROELECTRIC POTENTIAL.

--BY THIRD WORLD STANDARDS, A WELL DEVELOPED INFRASTRUCTURE AND INDUSTRIAL BASE.

--THE IMPETUS OF FOUR YEARS OF SUSTAINED GROWTH FUELED BY PETROLEUM INCOME AND CHARACTERIZED BY MAJOR DEVELOPMENT PROJECTS INTENDED TO TRANSFORM THE ECONOMY WITHIN THE SPACE OF FIVE YEARS.

5. THE SURGE IN PETROLEUM INCOME HAS ALSO BEEN RESPONSIBLE DIRECTLY OR INDIRECTLY FOR MANY OF THE COUNTRY'S GROWING ECONOMIC PROBLEMS. THESE INCLUDE:

--BALANCE OF PAYMENTS - VENEZUELA'S IMPORT BILL HAS GROWN BY ABOUT 225 PERCENT SINCE 1973 TO AN ESTIMATED 1977 LEVEL OF \$8.5 BILLION, AND WILL PROBABLY AMOUNT TO \$10.5 BILLION IN 1978 UNLESS EFFECTIVE RESTRICTIVE ACTION IS TAKEN. EXPORT REVENUE, MAINLY OIL, ROSE TO \$10.1 BILLION IN 1977 ACCORDING TO PRELIMINARY GOV ESTIMATES. BECAUSE NO DECISION WAS TAKEN TO INCREASE OIL PRICE AT THE RECENT OPEC MEETING AND BECAUSE WE ANTICIPATE VENEZUELA WILL MAINTAIN ABOUT THE SAME VOLUME OF OIL IN 1978 AS IN 1977, WE ASSUME EXPORT REVENUE WILL BE ABOUT \$10 BILLION THIS YEAR. THUS, IN 1978, VENEZUELA WILL PROBABLY EXPERIENCE ITS FIRST TRADE DEFICIT IN DECADES.

-- INFLATION - IN SPITE OF MONETARY MEASURES TAKEN IN JULY OF LIMITED OFFICIAL USE

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1977, THE MONEY SUPPLY GREW BY AN ESTIMATED 23 PERCENT IN 1977 TO BS.61 BILLION. THE CPI REGISTERED AN INCREASE OF 8 PERCENT; BECAUSE 65 PERCENT OF THE CPI MARKET BASKET CONSISTS OF PRICE CONTROLLED ITEMS, WE ESTIMATE THE PRICE LEVEL MAY HAVE INCREASED BY AS MUCH AS 15 PERCENT. ACCORDING TO THE BANCO CENTRAL, THE GOV EXPECTS THE CPI TO INCREASE AN ADDITIONAL 10 PERCENT IN 1978. GOVERNMENT EFFORTS TO CONTROL MONEY SUPPLY GROWTH AND ESTABLISH PRICE CONTROLS HAVE BEEN ONLY PARTIALLY SUCCESSFUL. PRODUCTION IN KEY SECTORS OF THE ECONOMY HAS NOT KEPT PACE WITH DEMAND, THUS CREATING INFLATIONARY PRESSURES AND FORCING INCREASING RELIANCE ON IMPORTS.

-- PUBLIC SECTOR FINANCES - CENTRAL GOVERNMENT EXPENDITURES, AMOUNTING TO ONLY \$3.5 BILLION IN 1973, TOTALLED \$12 BILLION IN 1977, AND, BECAUSE 1978 IS AN ELECTION YEAR, THEY ARE EXPECTED TO INCREASE TO ALMOST \$14 BILLION DURING THE NEXT TWELVE MONTHS. ON THE REVENUE SIDE, THE PETROLEUM SECTOR CANNOT BE EXPECTED TO PRODUCE MORE THAN BS.30 BILLION. DUE TO THE INABILITY OF THE GOV TO PUSH THROUGH TAX REFORM IN 1976 AND 1977, OTHER REVENUE WILL PROBABLY NOT EXCEED BS.20 BILLION, LEAVING BS.10 BILLION OR MORE OF THE REGULAR BUDGET TO BE FINANCED PRINCIPALLY THROUGH BORROWING ABROAD. ACCORDING TO BANCO CENTRAL SOURCES, THE LOCAL MONEY MARKET CAN ONLY ABSORB BS.2.5 BILLION IN PUBLIC OFFERINGS IN 1978. STATE ENTERPRISES ARE MAKING HEAVY DEMANDS ON LIMITED REAL AND HUMAN RESOURCES WITH LITTLE IMMEDIATE RETURN ON THEIR INVESTMENT. THE PRESIDENT HAS ADMITTED PUBLICLY THAT VENEZUELA NO LONGER HAS THE RESOURCES TO FINANCE ALL OF ITS PLANNED INVESTMENTS AND WILL BE FORCED TO PERMIT PRIVATE INVESTMENT IN AREAS HERETOFORE RESERVED TO THE PUBLIC SECTOR.

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--DEBT - THE GOV, WHICH HAS BORROWED ABOUT \$3 BILLION ABROAD IN THE LAST 15 MONTHS, CAN BE EXPECTED TO RETURN TO THE MARKET FOR AN ADDITIONAL \$3-4 BILLION IN 1978. THE MONEY IS URGENTLY NEEDED TO MAINTAIN FOREIGN EXCHANGE RESERVE LEVELS, FINANCE BUDGETARY DEFICITS AND PAY FOR IMPORTS OF CAPITAL GOODS ESSENTIAL TO THE COUNTRY'S DEVELOPMENT PROGRAM. WHILE IN THE STRICTLY FINANCIAL SENSE THE COUNTRY CAN AFFORD TO INCUR THIS KIND OF DEBT (DEBT SERVICE OBLIGATIONS ARE ESTIMATED NOT TO EXCEED 20 PERCENT OF EXPORT EARNINGS DURING ANY ONE OF THE NEXT FIVE YEARS AND DIMINISH THEREAFTER), TO THE EXTENT THE PROCEEDS FROM THESE LOANS ARE SPENT DOMESTICALLY, THEY ARE INFLATIONARY, THUS COMPLICATING THE PRICE PROBLEM CONSIDERABLY.

--FINALLY, WHILE NOT LIKELY TO REACH CRISIS PROPORTIONS DURING THE NEXT TWO YEARS, THE PROBLEM OF SHORTAGES OF HUMAN RESOURCES IS A CRITICAL ONE AFFECTING EVERY ASPECT OF THE ECONOMY, PRIVATE AND PUBLIC SECTOR ALIKE.

4. OUTLOOK. THE IMPACT OF THE FORTHCOMING PRESIDENTIAL ELECTIONS ON THE PERFORMANCE OF THE ECONOMY IN 1978 AND BEYOND CANNOT BE OVEREMPHASIZED. THE CAMPAIGN IS WELL UNDER WAY, AND IT IS UNLIKELY THAT THE GOV WILL IMPLEMENT POLITICALLY
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UNPALATABLE MEASURES SUCH AS TAX REFORM AND RATIONALIZATION OF PRICE CONTROLS THIS YEAR, REGARDLESS OF THE ECONOMIC NECESSITY FOR SUCH MOVES. LIMITED CONTROLS ON IMPORTS AND OUTFLOWS OF FOREIGN EXCHANGE HAVE BEGUN TO BE IMPLEMENTED, AND ADDITIONAL

MOVES CAN BE EXPECTED. NEVERTHELESS A BALANCE OF PAYMENTS DEFICIT OF \$500 MILLION -\$ 1 BILLION CAN BE EXPECTED AS EXPENDITURES FOR PLAN V PROJECTS CONTINUE THEIR UPWARD TREND. REVENUE SHORTFALLS WILL BE FINANCED BY DRAWDOWNS ON RESERVES OF FOREIGN EXCHANGE AND BY CONTINUED LARGE BORROWINGS ABROAD. UPWARD PRESSURE ON PRICES WILL CONTINUE AS GOVERNMENT SPENDING INCREASES OVERWHELM THE GOV'S EFFORTS TO COMBAT INFLATION.

5. PRIVATE SECTOR SPENDING AND INVESTMENT WILL TEND TO DECLINE AS THE YEAR GOES ON. DECISION MAKERS WILL WISH TO DEFER INVESTMENT DECISIONS UNTIL THE ELECTIONS AND FOR SEVERAL MONTHS THEREAFTER, WHILE THEY ASSESS THE POLICIES AND PROGRAMS OF THE NEW ADMINISTRATION REGARDLESS OF WHO WINS, THE NEW PRESIDENT WILL NEED SEVERAL MONTHS TO ASSESS GOALS AND PRIORITIES IN THE ECONOMIC AREAS. THE TENDENCY WILL BE FOR THE NEW ADMINISTRATION TO TAKE THE TOUGH DECISIONS AS SOON AS POSSIBLE, IN THE FIRST YEAR IF POSSIBLE, THUS MITIGATING THE IMPACT ON THE LONGER TERM POLITICAL FORTUNES OF THE GOVERNING PARTY.

6. WE EXPECT THE NEW ADMINISTRATION TO CONSIDER ACTION IN THE FOLLOWING AREAS:

-- TAXATION - NO ONE DENIES THAT VENEZUELA TAX LAWS ARE INADEQUATE TO THE SITUATION FACING THIS COUNTRY AND THAT BOTH REFORMS AND ADDITIONAL REVENUE ARE BADLY NEEDED. FOR MANY YEARS, PETROLEUM REVENUES HAVE BEEN THE MAIN SOURCE OF INCOME TO THE GOV. EXCLUDING PETROLEUM, VENEZUELA'S TAX BURDEN, MEASURED AS THE RATE OF NONPETROLEUM REVENUES LIMITED OFFICIAL USE

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TO NONPETROLEUM GDP HAS STAYED AT ABOUT 8 PERCENT DESPITE ABSOLUTE INCREASES IN REVENUE FROM THIS SOURCE IN RECENT YEARS. ADDITIONAL TAXES ON INDIVIDUALS AND CORPORATIONS WOULD REDUCE GROWTH OF THE MONEY SUPPLY, MITIGATE CONSUMER DEMAND FOR IMPORTED AND DOMESTIC GOODS, AND PROVIDE A MEANS TO OVERCOME FISCAL DEFICITS. THUS TAX REFORM COULD HELP IMMENSELY IN THE EFFORT TO FIGHT INFLATION, REDUCE THE IMPORT BILL AND PROVIDE THE GOVERNMENT WITH THE RESOURCES FOR CONTINUED DEVELOPMENT.

--INFLATION - TAX REFORM, AS NECESSARY AS IT IS, TAKES TIME TO IMPLEMENT. BY 1979 THE GOV WILL PERCEIVE AN URGENT NEED TO TAKE STEPS TO CONTROL INFLATION THROUGH MONETARY MEASURES AND PRICE CONTROLS. ATTEMPTS WILL BE MADE TO REDUCE GOVERNMENT SPENDING, PROBABLY BY STRETCHING OUT MAJOR DEVELOPMENT PROJECTS AND PERMITTING GREATER PRIVATE PARTICIPATION IN AREAS FORMERLY RESERVED TO THE PUBLIC SECTOR.

-- BALANCE OF PAYMENTS - DEPENDING ON THE SITUATION, THE GOV

MAY BE FORCED TO IMPLEMENT IMPORT RESTRICTIONS AND EXCHANGE CONTROLS MORE STRINGENT THAN IN THE PAST. UNLESS THERE IS A MAJOR CHANGE IN THE SITUATION EWE BELIEVE A CHANGE IN THE VALUE OF THE BOLIVAR IS UNLIKELY IN 1978; AFTER THE ELECTIONS, HOWEVER, THE LIKELIHOOD OF THIS HAPPENDING IS INCREASED, ALTHOUGH THE NEW ADMINISTRATION WILL PROBABLY TRY OTHER MEASURES FIRST TO CORRECT THE BALANCE OF PAYMENTS SITUATION.

7. THE NET EFFECT OF THESE DECISIONS WILL BE TO DEFLATE THE ECONOMY, AT LEAST TEMPORARILY. AFTER THE NEW ADMINISTRATION GETS ESTABLISHED AND HAS THE TOUGH DECISIONS OUT OF THE WAY, GROWTH WILL RESUME PROVIDED INVESTOR CONFIDENCE IS REESTABLISHED. HOWEVER, WE EXPECT THE RATE OF GROWTH TO BE LOWER THAN THAT WHICH CHARACTERIZED THE 1974-77 BOOM PERIOD.

8. THIS PROJECTION ASSUMES CONTINUED POLITICAL STABILITY IN LIMITED OFFICIAL USE

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VENEZUELA. IT ALSO ASSUMES CONTINUED OIL REVENUES AT APPROX. THE 1977 LEVEL. VENZEULA WILL MISS THE 5-8 PERCENT INCREASE IN OIL REVENUES IT SOUGHT AT THE DECEMBER OPEC MEETING, SINCE THIS WILL MEAN A LOSS OF ABOUT \$800 MILLION IN INCOME THIS YEAR. BUT THE REVENUE CAN BE MADE UP IN BORROWINGS OVER THE SHORT TERM AND THE ONE-YEAR LOSS BY ITSELF WILL HAVE LITTLE SIGNIFICANT IMPACT ON VENEZUELA'S ECONOMIC FORTUNES.

HOWEVER, ANY SUBSTANTIAL DECREASE IN OIL REVENUES, EITHER THROUGH PRICE DECLINES OR AN INABILITY TO MARKET PRODUCTION OR BOTH, WOULD HAVE WIDESPREAD CONSEQUENCES FOR THE COUNTRY, BOTH POLITICAL AND ECONOMIC. DEPENDING ON THE DEGREE OF THE REDUCTION, IT COULD RESULT IN DISINTERMEDIATION IN THE BANKING SYSTEM, CAPITAL FLIGHT, A VITIATED DEVELOPMENT PLAN, UNEMPLOYMENT, ECONOMIC RECESSION AND POLITICAL UNREST. VAKY

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